Office Supreme Court, U.S.
FILED
JUN 3 1963
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1963

No. [redacted] 183

WALTER A. SHEAFFER, II, and JOHN D. SHEAFFER, Executors of the Estate of CRAIG R. SHEAFFER, Deceased,

and

VIRGINIA D. SHEAFFER, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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vs.

COMMISSIONER OF INTERNAL REVENUE

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The following exhibits are separately certified:

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IN THE

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OCTOBER TERM, 1962

No.

WALTER A. SHEAFFER, II, and JOHN D. SHEAFFER, Executors of the Estate of CRAIG R. SHEAFFER, Deceased,

and

VIRGINIA D. SHEAFFER, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Walter A. Sheaffer, II, and John D. Sheaffer, executors of the estate of Craig R. Sheaffer, deceased, and Virginia D. Sheaffer petition for a writ of certiorari to review the decision of the United States Court of Appeals for the Eighth Circuit in this case.

OPINIONS BELOW

The opinion of the Tax Court of the United States (Appendix A, *infra*, pp. 1a-13a) is reported at 37 T.C. 99. The opinion of the United States Court of Appeals

for the Eighth Circuit (Appendix B, *infra*, pp. 14a-23a) is reported at 313 F. 2d 738.

JURISDICTION

The judgment of the United States Court of Appeals for the Eighth Circuit (Appendix C, *infra*, p. 24a) was entered on February 13, 1963. A timely application for rehearing was denied on March 6, 1963. The jurisdiction of this court is invoked under 28 U.S.C. sec. 1254(1).

QUESTION PRESENTED

Is the grantor of a trust taxable on trust income used by the trustee:

(a) To pay the gift tax resulting from the establishment of the trust; *and*

(b) To repay a loan obtained by the trustee for payment of the gift tax,—

where the gift to the trustee is subject to the trustee's prior commitment to pay the resulting gift tax?

Is the grantor thus taxable under (a) or even (b) despite the non-taxability (not controverted by the Commissioner) of such income if the grantor had made the same gifts not in trust?

STATUTES AND REGULATIONS INVOLVED

The 1939 Internal Revenue Code is applicable to the gift tax; the 1954 Code is applicable to the income tax.

The relevant provisions of the 1939 Code are:

Sec. 1000. Imposition of Tax, 53 Stat. 1, 144 as amended
Sec. 1008. Payment of Tax, 53 Stat. 1, 148
Sec. 1009. Lien for Tax, 53 Stat. 1, 149

The relevant provisions of the 1954 Code are:

Sec. 61. Gross Income Defined, 68A Stat. 1, 17
Sec. 677. Income for Benefit of Grantor, 68A Stat. 1, 230

The relevant provisions of the gift and income tax regulations are:

Treasury Regulations 108 (1939 Code)
Sec. 86.1 Imposition of Tax
Sec. 86.2 Transfers Reached
Sec. 86.34 Donor Liable For Tax
Sec. 86.35 Lien For Tax
Treasury Income Tax Regulations (1954 Code)
Sec. 1.677(a)-1. Income for Benefit of Grantor; General Rule

The foregoing sections of the statute and the regulations (or relevant portions thereof) are printed as Appendix D, *infra*, pp. 25a-30a.

STATEMENT OF THE CASE

Craig R. Sheaffer and Virginia D. Sheaffer, of Fort Madison, Iowa, were husband and wife. For the calendar years 1954 and 1955 they filed joint Federal income tax returns. On Craig's death while this case was pending in the Tax Court his estate was substituted as a party.

On February 2, 1954, Virginia D. Sheaffer created four separate trusts by a single trust instrument (Exhibit 3-C to Stipulation of Facts, T.C.R. Doc. No. 8).[1]

[1] No record was printed for the use of the Court below, which heard this case on the original Tax Court record. This reference and similar ones hereafter are to the original Tax Court record, certified by and each document numbered by the Clerk of that Court.

Harris Trust and Savings Bank of Chicago was named trustee. Each trust was for the benefit of one of her four children and his or her family. The corpus of the trust consisted of shares of common stock of W. A. Sheaffer Pen Company, Fort Madison, Iowa, aggregating 70,000 shares in all (Stip. of Facts, para. 3, T.C.R. Doc. No. 8). The transfer of these shares of stock by the settlor to the trustee resulted in a Federal gift tax. As to the payment of this tax the trust agreement of February 2, 1954, provided as follows:

> "SECTION I: The trustee agrees that, to the full extent of the value of the corpus of the trust estate and the income therefrom, it will assume and pay all federal and state gift taxes (including all penalties and interest thereon, if any) which shall or may be assessed or become due from any one by reason of the transfer, assignment and delivery to it of the property listed in Schedule A or by reason of the creation of the trust estate hereunder; and, notwithstanding any other provision herein, the trustee agrees to assume, and to indemnify and hold all persons whomsoever harmless against and from, any obligation or liability whatsoever which they, or any of them, shall or may have for the payment of such taxes or for the reimbursement of, or contribution to, the trustee or any person whomsoever on account of the payment of such taxes. The trustee is authorized and agrees to obtain a loan in an amount sufficient to pay all such taxes and to pledge, or otherwise to apply such part or all of the corpus and income of the trust estate, and to take such other action, as shall be required or deemed advisable by the trustee in order to secure the loan. The trustee agrees to apply the proceeds of such loan in payment of such taxes."

Craig R. Sheaffer consented to the foregoing gifts in trust made by his wife and thereby these gifts were

considered as made one-half by each of them (Stip. of Facts, para. 4, 5, T.C.R. Doc. No. 8). The trustee prepared gift tax returns for Craig and Virginia for 1954, filed them with the District Director of Internal Revenue, Des Moines, Iowa, on March 14, 1955 (the day before the returns and payments were due), and at the same time paid the total gift taxes shown on the returns of $327,307.04 (Stip. of facts, para. 4-7, T.C.R. Doc. No. 8). Of this amount $188,607.04 was paid with trust income from the four trusts accumulated up to that time and $138,700 from proceeds of a loan obtained by the trustee in accordance with Section I of the trust agreement (Stip. of Facts, para. 7, T.C.R. Doc. No. 8).[2]

The trustee received dividends on the Pen Company stock in the amount of $140,000 in 1954 and $155,500 in 1955; a total of $295,500. Of such total income $188,607.04 was used to pay gift taxes; the balance of $66,892.96 was received and applied to repayment of the loan after the gift taxes had been paid.

The trustee filed fiduciary income tax returns for 1954 and 1955 for the four trusts, showing the income received by each in those years, including the income represented by the dividends on the Pen Company stock, and paid the income taxes shown to be due on such income (Stip. of Facts, para. 7, 14, T.C.R. Doc. No. 8 and Ex. 13-M through 20-T).

The respondent in his notice of deficiency (T.C.R. Doc. No. 2) added to taxable income of petitioners

[2] The respondent adjusted the value of the Sheaffer shares upward, and in 1958 the trustee paid additional gift taxes of $27,657.24 plus interest of $4,824.48, making the total gift taxes paid $354,964.28 after diminishing the value of the taxable gifts by the amount of the gift tax (Stip. of Facts, para. 9, T.C.R. Doc. No. 8). The amount of the gift tax is not now in dispute.

$140,000 for 1954 and $115,500 for 1955 (including the $66,892.96 received after payment of the gift tax) with the following explanation for each year:

> "It is determined that Virginia D. Sheaffer, as a donor, and Craig R. Sheaffer, as a beneficiary,[3] realized income of $140,000 in this year [1954, and $115,500 in 1955] from Virginia D. Sheaffer trusts which were created under a trust agreement dated February 2, 1954, as such income was applied by the trustee as a partial payment of a legal obligation of these taxpayers."

The deficiencies so asserted were determined by the Tax Court in the amounts of $120,008.64 for 1954 and $78,352.25 for 1955, a total of $198,360.89 (T.C.R. Doc. No. 14).

The Court of Appeals for the Eighth Circuit affirmed (Appendix B and C, *infra*, pp. 14a-24a).

REASONS FOR GRANTING THE WRIT

The donors, the donees, and the gift assets were all liable for the gift tax, which is an excise. The donors reserved nothing by way of principal or income from the gift and were in no way enriched by the creation or satisfaction of the gift tax liability. The Government has not contended that the donors would have realized income if they had made these gifts outright rather than in trust. Nevertheless the Court below held that petitioners, as donors, realized taxable income from the trustee's payment of the gift tax. The Court below thus decided an important question of income tax law which has not been, but should be, decided by this Court. The decision below is in conflict with a decision of the Sixth Circuit involving

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[3] The Tax Court correctly treated both Virginia and Craig as donors.

a gift tax payment under similar circumstances. It is also in conflict with important principles of law established by this Court for the determination of taxable income.

I. THE DECISION BELOW CONFLICTS WITH THE SIXTH CIRCUIT'S HOLDING IN COMMISSIONER v. ESTATE OF MORGAN

A. In Morgan, Trust Income Used to Repay the Trust's Loan (Rather Than to Pay Gift Tax Directly) Was Not Taxable to the Grantor, Since She Was Not Liable for the Loan.

In its *per curiam* decision, ___ F. 2d ___, 11 A.F.T.R. 2d 1228 (1963), the Sixth Circuit adopted the findings of fact and opinion of the Tax Court, 37 T.C. 981 (1962). That Tax Court opinion and the Sixth Circuit decision affirming it are set forth as Appendix E, *infra*, pp. 31a-38a. In both the *Morgan* and *Sheaffer* cases the settlors established trusts for their children. In each case by the terms of the trust instrument the trustee was responsible for the payment of the gift tax. In each case, pursuant to authorization in the trust instrument, the trustee borrowed money, secured by the trust's assets, and applied the proceeds of the loan to payment of the gift tax. The settlor was not a party to the loan nor liable for its repayment. In *Morgan* the entire amount of the gift tax was borrowed, while in *Sheaffer* a part of it was borrowed—the balance of the gift tax being paid with accumulated trust income. In each case the trustee applied subsequent trust income to the repayment of the loan.

In *Sheaffer* the income so applied in payment of the loan was held taxable to the settlor. In *Morgan* it was not. In *Morgan* the Tax Court pointed out that payment of the tax with borrowed money is essentially the same as payment with principal. The subsequent

use of income to repay the loan—in effect to restore the principal—favors the corpus beneficiaries at the expense of the income beneficiaries. But it does not benefit the settlor, provided she retains no beneficial interest in the trust.

The very same is true with respect to the $66,892.96 of 1955 *Sheaffer* income used to repay the loan for which the trust but not the settlor was liable. The only remaining difference between the two cases is that the $66,892.96 of *Sheaffer* income was received in the same year in which the gift tax was paid, while the *Morgan* income was received in a subsequent year, so that the year of the gift tax payment was not before the Court in *Morgan*.

The Court below did not attempt to distinguish *Morgan*. It simply stated that *Morgan* was not "controlling or dispositive" and took note of the fact that Morgan at that time was on appeal before the Sixth Circuit. Appendix B, p. 22a.

Surely there is no tenable distinction here in terms of the statute under which the Sheaffers were held liable. Section 677 of the Internal Revenue Code of 1954, 68A Stat. 1, 230, taxes a grantor on trust income that "is, or . . . may be . . . distributed to the grantor." Thus the test is how the specific income involved is or may be used. Once the gift tax has been paid, from that instant on not one cent of subsequent income is or can possibly be used to pay it. This is equally true of subsequent income received in the same year and that received in the next year. Thus as to $66,892.96 of the *Sheaffer* income, the decision below is squarely and irreconcilably in conflict with *Morgan*. This conflict has already aroused public concern. See 12 U.S. Tax Week 712, 713 (April 19, 1963); 41 Taxes 259 (May, 1963).

B. The Decision Below Cannot in Any Respect Fairly Be Reconciled With Morgan.

The settlor in neither *Morgan* nor *Sheaffer* had any obligation to pay the money borrowed by the trustee. So it can not be said that the income applied in repayment of either loan satisfied a legal obligation of either settlor. And *Morgan* so held; but *Sheaffer* did not.

The only variation of any significance between the two cases was the use of the trust income in *Sheaffer* for the direct payment of a part of the gift tax. We submit it makes no difference for income tax purposes whether the trustee pays the settlor's obligation with income or borrows money and uses the income to repay the loan. This is too fine a distinction on which to predicate large differences in tax liabilities. The three dissenting Tax Court judges in the *Morgan* case argued that there was no valid distinction here, but they, like the Court below, failed to appreciate the reasons why judgment in both cases should have gone for the taxpayers. We now turn to those considerations.

II. THE DECISION BELOW IS IN CONFLICT WITH IMPORTANT AND WELL-ESTABLISHED PRINCIPLES GOVERNING CONSTRUCTIVE RECEIPT OF INCOME.

A. The Donors Did Not Constructively Receive Income from the Gift Tax Payment, Any More Than if They Had Made the Same Gift Not in Trust.

Section 677 of the Internal Revenue Code of 1954, 68A Stat. 1, 230, taxes income "distributed to the grantor" or "held or accumulated for future distribution to the grantor." But in the present case no payment was made "to" the grantor. The question is one of constructive receipt.

The guiding principles of constructive receipt are found in the cases decided under section 61(a) of

the 1954 Code, 68A Stat. 1, 17, and its predecessors. That section taxes "income . . . derived" by the taxpayer. If such cases were not relevant, then indeed we would be in uncharted seas. When the question is whether a payment made to somebody else is attributable to the taxpayer, there is no difference in the standards we should apply in deciding whether income has been "derived" by the taxpayer (sec. 61) from those we use in deciding whether income has been "distributed to" him (sec. 677). Under both sections the question is whether the transaction is in substance a payment to the taxpayer. The ruling cases in this field would have been decided the same way whether or not trusts were involved.

The Court below relied on *Staley* v. *Commissioner*, 136 F. 2d 368 (5th Cir. 1943), which presented no question of constructive receipt. Trust income in that case was "distributed to the grantor" (sec. 677). It was irrelevant that the grantor wanted the money to use in payment of the gift tax, when he could do with it as he saw fit. The grantor in this case received nothing.

Neither the Commissioner nor the Court below has contended that the taxpayers here would have received taxable income from these transactions if their gift had not been made in trust. If a donor makes a gift of the legal title to property, and the donee pays the gift tax, no income is realized by the donor, whether the funds used are from principal or income. The Court below based its decision entirely upon "the basic fact that the transfer in this case was made in *trust*" (Court's emphasis), and thereupon disregarded all the non-trust cases cited by the taxpayers showing the standards that have been developed for determin-

ing the constructive receipt of income. Appendix B, p. 22a. In this way the Court below disregarded important and well established legal principles because of form—the trust form of the transaction.

B. The Only Purpose of Section 677 Is to Prevent Avoidance, Through the Use of Trusts, of Taxes Otherwise Applicable.

It was no part of the Congressional purpose to tap a new source of income when it enacted the predecessor of section 677. Rather it was designed to meet and overcome the growing use of trusts as a device for escaping taxes which would be applicable in the absence of the trust device.

Over the years Congress has been engaged in a defensive battle to keep the tax base from being whittled away by newer and more ingenious trusts. This is apparent from the committee reports as section 677 has developed from its beginning in the Revenue Act of 1924, 43 Stat. 253, 257. H. Rep. No. 179, 68th Cong., 1st Sess., p. 21 (1924); S. Rep. No. 665, 72nd Cong., 1st Sess., pp. 34-5 (1932). This Court made the same point in *Helvering* v. *Stuart*, 317 U.S. 154, 167 (1942), when it said:

> "Section 167 [the predecessor of 677] took its present form in the Revenue Act of 1932. It was enacted especially to prevent avoidance of surtax by the trust device, when the income really remained in substance at the disposal of the settlor . . . It is to be interpreted in the light of its purpose for the protection of the federal revenue . . . Of course, where the settlor or donor is not actually or in substance a present or possible beneficiary of the trust, he escapes the surtax by a gift in trust."

Congress did not undertake to make payments taxable in a trust situation which would be non-taxable in a

non-trust situation. The taxpayer should not be rewarded or punished for casting his transaction in the form of a trust.

In making an unwarranted distinction between trust and non-trust cases, the court below mistakenly relied on *Douglas* v. *Willcuts*, 296 U.S. 1 (1935), as a case decided under the forerunner of Section 677. In fact *Douglas* was decided under the predecessor of Section 61. The Court below missed the major lesson in *Douglas* and in *Helvering* v. *Fuller*, 310 U.S. 69 (1940), that transfers in trust produce the same tax consequences as the same transactions in the form of outright gifts. "The creation of a trust . . . leaves the nature of the transaction unaltered." *Douglas* v. *Willcuts*, 296 U.S. 1, 9 (1935).

C. Payment of a Liability by One Obligor Is Not Income to a Co-obligor.

The concept of constructive receipt of income through the discharge of a legal obligation has been developed by decisions of this Court. The two landmark cases forming the basis of this doctrine are *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716 (1929) (payment of income tax by another); and *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931) (forgiveness by a creditor of part of an indebtedness). *Douglas* v. *Willcuts*, 296 U.S. 1 (1935), showed how the same principle (under the predecessor of section 61) can be applied to a trust whose income is devoted to satisfaction of the settlor's legal obligation. This brings us to the area of Section 677, which is a special statute dealing with trusts, but where the principles are the same insofar as constructive receipt is concerned.

This court has not had occasion to mark out the limits of this doctrine. The instant case discloses the need for such a determination. Some of the Courts of Appeals have done so in two respects applicable to this case.

One such limitation is the proposition that where two or more people are liable for a debt, anyone can pay it without giving rise to income on the part of the others. The second limitation is treated in point D, *infra*, p. 13. The outstanding case on this point is *Ruben* v. *Commissioner*, 97 F. 2d 926 (8th Cir. 1938). In that case a corporate judgment debtor compromised and paid a tort judgment which was also entered against individuals including the taxpayer. The Commissioner determined that Ruben had realized taxable income by reason of the payment of his legal obligation. The Court of Appeals held that it did not matter who was primarily liable for the judgment, and that none of the judgment debtors received any income from the settlement and payment made by the corporate debtor.

To the same general effect are *Tucker* v. *Commissioner*, 226 F. 2d 177 (8th Cir. 1955); and *Commissioner* v. *Hopkinson*, 126 F. 2d 406 (2nd Cir. 1942).

D. Income Does Not Arise from Discharge of An Obligation Gratuitously Incurred.

At one time it might have been argued that the doctrine of *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931), should be extended to the point where any taxpayer would realize income from a diminution in liabilities unaccompanied by a diminution in assets. The

courts have recognized, however, that there are situations in which that would be unfair and would seriously strain the concept of income. *Bowers* v. *Kerbaugh-Empire Co.*, 271 U.S. 170 (1926), is authority for the proposition that the entire transaction may be viewed to determine whether taxable income was derived from the cancellation of indebtedness for less than full consideration.

The Courts of Appeals have correctly applied this principle in situations where the cancelled indebtedness was incurred in the first instance without consideration or benefit to the taxpayer. It would be unreasonable to say a taxpayer realizes income simply by escaping liability. Good examples of this proposition are: *Ruben* v. *Commissioner*, 97 F. 2d 926 (8th Cir. 1938) (payment of a tort judgment by a co-defendant); *Bradford* v. *Commissioner*, 233 F. 2d 935 (6th Cir. 1956) (redemption at half price of a note given for another person's indebtedness); *Commissioner* v. *Rail Joint Co.*, 61 F. 2d 751 (2nd Cir. 1932) (repurchase at less than face value of bonds issued to stockholders as a dividend); see also Surrey, "The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness," 49 Yale L.J. 1153 (1940).

Moving into the trust field, the same consideration limits the applicability of Section 677 of the 1954 Code. The Fifth Circuit in *Edwards* v. *Greenwald*, 217 F. 2d 632, 634 (5th Cir. 1954) relied on the same kind of facts that should have led to a decision for the taxpayers in the present case:

> "[I]n the instant case the indebtedness of the trustees individually [the grantor-taxpayers] was

> incurred contemporaneously with the establishment of the trusts and was incurred solely for accommodation of the trust and under the trust instruments no benefit or right to receive income was reserved to the trustees as individuals. This being the situation it follows that the trustees' payment of this indebtedness . . . simply operated to increase the corpus of the trusts from which neither of the trustees individually could receive either income or corpus."

Helvering v. *Blumenthal*, 296 U.S. 552 (1935), reversing 76 F. 2d 507 (2nd Cir. 1935),[4] is not to the contrary. That case is simply *Kirby Lumber* in trust form. The taxpayer borrowed money. Such a receipt would have been income in the first instance but for the obligation to repay it. In *Kirby Lumber* the obligation to repay was partially cancelled, whereas in *Blumenthal* trust income was used to discharge the obligation. In the present case the taxpayers had no pre-existing indebtedness. In incurring the gift tax indebtedness they obtained no receipt or benefit.

E. The Primary or Secondary Nature of a Discharged Obligation Is Not a Valid Criterion for Determining the Realization of Income.

A gift tax is an excise payable by the donor, the donee, or out of the gift assets. Internal Revenue Code of 1939, sections 1000(a), 1008(a), 1009.[5] Payment by one extinguishes the liability of others but

[4] In that case the settlor was held taxable not as a grantor under the predecessor of Sec. 677 but as a beneficiary under Sec. 162(b) of the Revenue Act of 1928, 45 Stat. 791, 838.

[5] In this case the applicable Internal Revenue Code pertaining to the income tax is the 1954 Code, and the applicable Code pertaining to the gift tax is the 1939 Code.

does not thereby give rise to taxable income for the others. Donor, donee, and gift assets all become liable at the time of the gift, although they are subject to different rules as to whether and when payment is required. Section 1009, Internal Revenue Code of 1939, 53 Stat. 1, 149.

The Court below thought it important that the donor's liability for the gift tax is "primary" in terms of sections 1008 and 1009 of the 1939 Code. The Court below also thought it important that the tax was paid the day before it was due rather than the day after. Appendix B, p. 19a. The Court has confused liability for the tax, which was common to all, with the requirement for payment on different dates by donor and donee.

The correct principle to apply is that one obligor does not receive income when a co-obligor pays the obligations. It makes no difference whether the liability of one of the obligors may be in a sense "primary", as held in *Ruben* v. *Commissioner*, 97 F. 2d 926 (8th Cir. 1938). If it were otherwise, a tortfeasor servant, primarily liable, would receive income on the payment of the victim by his master.

Congress provided a comprehensive plan for seeing that the gift tax was paid. Apart from this objective it was not concerned with the problem of who made the payment. A similar legislative indifference appears in the collections excise taxes, such as those on transportation, dues, and admission fees. In fact, when the first gift tax act (1924) was being debated in the House of Representatives, the Chairman of the Ways and Means Committee (Representative William

R. Green) exhibited some confusion and little interest in determining where the impact of the tax would fall. In short, he considered it "immaterial" whether the donor or donee paid the tax. 65 Cong. Rec. 3120 (February 25, 1924).

The Government has no justification for requiring payment of the gift tax from donor rather than from donee. If a donor plans to make a gift and pay the tax himself, he can take the amount he has available for the purpose and figure out what portion of it should constitute the gift, so that the remainder, the correct amount of the tax, can be withheld. On the other hand, he can give the whole amount to the donee and require the donee to pay the tax. The amount of the Government's take from the gift tax is precisely the same, whether it comes from the donor, the donee, or the gift assets. Here the parties to the gift have by contract, in the light of applicable state law expressly made the donee primarily liable for the gift tax and responsible to the donor for seeing that it was paid.

CONCLUSION

In view of the importance of this case to the Federal tax laws, of the error in the decision of the United States Court of Appeals for the Eighth Circuit in disregarding general legal principles merely because of the involvement of a trust, and of the conflict between the decision below and the Sixth Circuit's decision in *Commissioner* v. *Estate of Morgan*, (Appendix E, p.

38a) the petition for a writ of certiorari should be granted.

Respectfully submitted.

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